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A Brave New World: Cryptocurrency, Blockchain, and the Complex and Ever-Changing Regulatory Framework

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Financial institutions large and small are investigating, and investing in, blockchain technology. The many and varied uses of blockchain will impact supply chain dynamics, money transfers, contracting and a multitude of commercial applications. Blockchain has the potential to be the most impactful invention since the industrial revolution. This article will help financial institutions understand three major issues: What is cryptocurrency? What are the regulatory challenges these new tokens face? And how do they play into existing banking obligations?

The business, financial and legal worlds are facing change at a breakneck rate. New technologies and new methods of raising money are not only creating innovative tools for doing business, they are actually creating entirely new business models. While it is difficult to say any one of them has a bigger impact on financial institutions than another, it is fair to say that anyone working within the financial industry must understand blockchain and cryptocurrency, and how criminal, regulatory and banking laws impact those products.

Financial institutions large and small are investigating, and investing in, blockchain technology. The many and varied uses of blockchain will impact supply chain dynamics, money transfers, contracting and a multitude of commercial applications. Blockchain has the potential to be the most impactful invention since the industrial revolution.

Arguably the most thought-provoking use of blockchain, especially in how it impacts regulatory and banking laws, is its application to cryptocurrency. The ubiquitous bitcoin has experienced such volatile surges in value over the past 18 months that it is both hailed as a great investment and a millennial Ponzi scheme. Indeed, cryptocurrency is becoming so ubiquitous that in May, the

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U.S. Securities and Exchange Commission ("SEC") launched a fake website purporting to sell HoweyCoins, a completely made-up cryptocurrency, purportedly to show the risks of fraud the SEC associates with initial coin offerings ("ICOs"). The fact that the SEC thinks enough to launch a phony offering illustrates not only the risks associated with ICOs but also their growing popularity. In fact, ICOs have already raised more money in the first quarter of 2018 than they did in the entirety of 2017.

But in any discussion about cryptocurrency, it is important to note what it is and what it is not. Once that is understood, it is easy to see where the concept will have impacts on more traditional financial institutions. While it is mission-impossible to predict how cryptocurrency will be regulated, it is a surefire bet to face increasing regulatory frameworks even in an environment of decreasing financial regulation in the U.S. Moreover, challenges will exist in fitting a bank's role in cryptocurrency into existing banking laws.

Our intent is to help financial institutions understand three big issues. What is cryptocurrency? What are the regulatory challenges these new tokens face? And how do they play into existing banking obligations?

WHAT IS BLOCKCHAIN AND CRYPTOCURRENCY?

Blockchain

The term blockchain refers to distributed ledger technology ("DLT"), a shared record of information that is maintained and updated by a network of computers rather than a central authority. This network is protected and secured by advanced cryptography. Blockchain requires a majority of market participants to agree on a transaction's validity before the ledger can be changed. Thereafter, absent the consensus of market participants, past transactions cannot be modified. Without a similar consensus and verification, new transactions cannot be added to the ledger.

Simply put, blockchain is a transaction ledger, which is neither easily modified nor disputed and therefore comes with an air of authority and reliability.

Cryptocurrency

For a token of value to be considered cryptocurrency, that token must be distributed and tracked via a blockchain. However, despite the name, not all, or even most, cryptocurrencies can be used in the same manner as traditional currencies. Moreover, some companies define their cryptocurrency as a security (subject to all the regulatory schemes which accompany that definition) while many others try very hard to ensure their tokens are not considered a security. These variables make it challenging to identify cryptocurrency.

Bitcoin, the most well-known cryptocurrency, typifies the difficulties in putting a singular definition on the term. On the one hand, bitcoin acts like currency. Like dollars, it can be exchanged for goods or services. On the other hand, bitcoin is traded as a commodity, with trading prices fluctuating dramatically over the course of time. Thus, bitcoin is both a store of value and an investment vehicle.

Utility vs. Security

Beyond well-known cryptocurrencies, many companies are creating new tokens to raise funds through the concept of ICOs. These offerings have garnered attention from regulatory bodies, from the SEC to the IRS. However, as companies make an effort to avoid regulatory schemes while using ICOs, some cryptocurrencies offered in an ICO is considered a utility token while others are considered security tokens.

The very specific purpose of a utility token is for a company to avoid selling a security. It is intended by the issuer to be the equivalent of a sale of a product. A utility token is not intended to be a security, and thus, in theory, its value is not directly tied into the value of the company.

Successfully labeling one's cryptocurrency as a utility token is of such cellular-level importance that it becomes part of the token's definition. If a utility token is not a security, it does not have to be sold like a security, thus avoiding all of the regulatory requirements which limit the sale of, and increase the cost of, a security.

In contrast to utility tokens are tokens which the issuer acknowledges is a security, aptly called security tokens. These are ICOs that recognize that the value of the currency will be tied directly to a common enterprise and the value of the company issuing the currency. The company issuing the ICO must therefore comply with laws and regulations related to the sale of securities.

REGULATORY CHALLENGES

Virtual currencies are intriguing to entrepreneurs and established businesses alike, prompting a wave of innovation, particularly in the financial services industries. Government regulators and enforcement agencies have not only taken notice but are also actively taking steps to assert jurisdiction and curb abuses. All of this has occurred as various virtual currencies still do not have a strict regulatory framework in which to operate and are simultaneously regulated as a security, a commodity and a currency.

Cryptocurrency as a Security

According to several reports, including the Wall Street Journal and online data aggregator Crunchbase, it is estimated that the ICO market raised

anywhere between $4 and $5 billion dollars during 2017.[1] The rapid rise in popularity of using blockchain for raising investment funds has drawn attention from several U.S. governmental agencies, but primarily the SEC.

The growing interest of the SEC can be seen by tracing its comments and conduct over the past year or two. On July 25, 2017 the SEC issued a report that found that digital tokens offered and sold by an online distributed organization known as the "DAO" were securities and therefore subject to the federal securities laws.[2] The report cautions market participants that offers and sales of digital tokens or coins may be subject to the requirements of the federal securities laws. According to a senior SEC enforcement official, "The innovative technology behind these virtual transactions does not exempt securities offerings and trading platforms from the regulatory framework designed to protect investors and the integrity of the markets."[3] In an attempt to be as clear as possible, the SEC further stated that the nation's securities laws apply to any new technology. "The federal securities laws apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology."[4]

On September 29, 2017 the SEC issued a civil complaint alleging that two ICOs were in fact selling unregistered securities and that the digital tokens or coins offered for sale did not exist.[5] According to the text of the SEC's

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[1] Russolillo, Steven, "Initial Coin Offerings Surge Past $4 Billion—and Regulators Are Worried," Wall Street Journal December 14, 2017, https://www.wsj.com/articles/initial-coin-offerings-surge-past-4-billionand-regulators-are-worried-1513235196; Page, Holden, "2017s ICO Market Grew Nearly 100x Q1–Q4," Crunchbase News, January 11, 2018. https://news.crunchbase.com/news/2017s-ico-market-grew-nearly-100x-q1-q4/.

[2] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017); SEC Rel. No. 81207, 34-81207, *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf.

[3] United States. Cong. Senate. Committee on Banking, Housing, and Urban Affairs. SEC Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC. February 6, 2018. 115th Cong. 1st sess. Washington: GPO, 2005 (statement of Jay Clayton, Commissioner, Securities and Exchange Commission).

[4] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017); SEC Rel. No. 81207, 34-81207, *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf.

[5] Securities and Exchange Commission. (2017, September 29) SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds [Press Release]. Retrieved from

complaint, the offering was designed to mislead investors. The SEC claimed that, fraudulently, the companies informed potential investors that each had teams of specialists working on the various projects and that the ICOs were backed by various investments in real estate and diamonds.

Then, in November 2017, the SEC issued a statement that ICO endorsements could be unlawful if tokens or coins sold are securities and the endorsing individuals did not disclose any amounts of compensation paid for the endorsement.[6] The SEC's statement also cautioned individual investors to conduct extensive research before investing in ICOs, noting that these investments are extremely volatile. Moreover, the SEC's statement noted that individual investors should do research to understand if a promoter's endorsement was "truly independent or a paid promotion."

Only a month after the November statement, the SEC issued an order against a company conducting an ICO. The ICO sought to raise capital to create a software "ecosystem" around an existing phone app allowing users to buy and sell digital tokens. The company represented to both investors and potential investors that the sale of its "utility tokens" did not pose a risk of implicating federal securities laws. The SEC disagreed and contacted the company. After receipt of the SEC's cease and desist order, the company immediately concluded the ICO offering and returned all the funds raised during the ICO to investors.[7]

Recently, SEC Commissioner Hester Peirce gave a very candid and exciting speech about how her organization is still grappling with the right way to regulate cryptocurrency. "We must be careful not to let our lack of familiarity with new technology breed anxiety and therefore bad regulation," she said in May at the Medici Conference. "There is a risk, when something truly innovative comes along, that regulators will focus only on the harms the innovation may bring and miss entirely the opportunity it presents to improve people's lives."[8]

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https://www.sec.gov/news/press-release/2017-185-0.

[6] Securities and Exchange Commission. (2017, November 1). *SEC Statement Urging Caution Around Celebrity Backed ICOs.* [Press Release] *available at* https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos.

[7] Securities and Exchange Commission. (2017, December 11) Company Halts ICO After SEC Raises Registration Concerns. [Press Release] *available at* https://www.sec.gov/news/press-release/2017-227.

[8] Securities and Exchange Commission. (2018, May 21). Beaches and Bitcoin: Remarks before the Medici Conference. [Press Release] *available at* https://www.sec.gov/news/speech/speech-peirce-050218.

Commissioner Peirce went on to say that "an analytical approach—defining an instrument by its function not its form—can be useful when we're confronted with something that seems entirely new and difficult to categorize." In the case of ICOs, the SEC seems to have decided—at least for now—that the function lines up with that of a security.[9]

Also in May, the SEC did what was unimaginable to many people. It launched a fake website purporting to offer for sale tokens called HoweyCoins (named, presumably, after the legal decision which has given rise to the most common definition of what constitutes a security). It is clear the SEC is intending to illustrate the risks of fraud to investors which it believes are attendant with ICOs (although Fortune accused the SEC of "trolling" cryptocurrency scammers). While it may seem obvious to most, the phony website actually has a link for people to make investments, leading to an SEC information page with "education tools" for people investing in cryptocurrency. This extreme step taken by the SEC reflects both its concern and the reason its regulatory imprint will only grow in this area.

Cryptocurrency as a Commodity

While the SEC is the primary one, it is not the only regulatory body with an interest in cryptocurrency. In 2015, the CFTC issued guidance indicating that cryptocurrency tokens could be considered commodities. In October 2017, the agency published "A CFTC Primer on Virtual Currencies."[10] The primer describes the CFTC's jurisdiction as being "implicated when a virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce."[11]

This statement was put to the test in early 2018. Relying at least in part on the primer, a federal court ruled that the CFTC had standing to bring a fraud lawsuit against Coin Drop Markets and its principle, Patrick McDonnell, on the basis they were commodity dealers. The court also held the plain meaning of the word "commodity" applied to the coins at issue and that the CFTC had broad leeway to interpret the federal law regulating commodities. In this sense, the court followed most of the CFTC's 2015 and 2017 guidance on the topic.

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[9] *Id.*

[10] *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, Respondents, CFTC No. 15-29 (2015) ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities."); *In re TeraExchange LLC*, CFTC No. 15-33 (2015) ("Further, Bitcoin is a commodity under Section 1a of the Act, 7 U.S.C. § 1a (2012), and is therefore subject as a commodity to applicable provisions of the Act and Regulations.").

[11] Commodities and Futures Trading Commission. (2017, October 17). *A CFTC Primer on Virtual Currencies.* [Press Release] *available at* https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf.

The fact that multiple agencies may be regulating the same products has not deterred the CFTC. The CFTC's primer states "[t]here is no inconsistency between the SEC's analysis and the CFTC's determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances." Depending on how the virtual currency or token is used it could be classified—and regulated—as a security, a commodity, or both.

Cryptocurrency as a Store of Value

While as of the date of this publication no country views virtual currencies as legal tender, in the U.S. the same anti-money laundering laws that govern fiat transactions also apply to cryptocurrencies. Virtual currency exchanges ("VCE") qualify as money transmitters ("MT"), a subcategory of money service businesses ("MSB"), under the Bank Secrecy Act.[12] The Federal Financial Institutions Examination Council's Examination Manual lists an MSB as a non-bank financial institution. In accordance with the federal rules and state legislation, an MSB is required to obtain licensure with the state(s) where it is incorporated and / or conducting business. In addition, MSBs are required to register with the Financial Crimes Enforcement Network ("FinCEN").

In 2013, FinCEN published FIN-2013-G001, Guidance on the Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual currencies. In this guidance FinCEN confirmed several Bank Secrecy Act interpretations and highlighted government recognition of Virtual Currency Exchanges as Money Transmitters. This meant that any entity conducting business as a virtual currency exchange would need to satisfy all of FinCEN's MSB requirements and immediately draft, create and implement an effective anti-money laundering compliance program.

The U.S. Attorney's Office for the Northern District of California used the 2013 FinCen guidance in its first enforcement action in 2015 against Ripple Labs, Inc. and its virtual currency exchange. FinCEN and the U.S. Attorney's Office fined Ripple Labs $700,000 in civil monetary penalties for its failure to report any suspicious activity and for its failure to implement an effective anti-money laundering program. It is important to note that Ripple Labs, Inc. and its subsidiary, XRP II, LLC also faced criminal charges in connection with the civil monetary penalties from the federal government. Ripple Labs was able to resolve the matter, paid its fine and on June 13, 2016 was awarded the second BitLicense by the New York Department of Financial Services after a "rigorous

[12] 31 U.S.C. § 5312(a)(2)19 and at 31 C.F.R. §§ 1010.100(t), 1010.100(ff).

review of [its] anti-money laundering, capitalization, consumer protection, and cyber security standards."[13]

BANKING REGULATIONS IMPACTING CRYPTOCURRENCY

Most entities transmitting any cryptocurrencies are required to register as an MSB if they are not federally insured depository institutions. Specifically, the Money Laundering Suppression Act of 1994 required all MSBs to register with FinCEN on a biannual basis. Like banks, all MSBs are required to have anti-money laundering programs and take actions as required by federal laws.

After September 11, 2001, the Patriot Act[14] expanded federal regulation of MSBs by making it a federal crime for an MSB to operate without a license in any state that required such a license. Additionally, states significantly upgraded the cost and fees associated with obtaining and operating an MSB. The Patriot Act also made it a federal crime to "knowingly conduct, control, manage, supervise, direct, or own all or part of an unlicensed money transmitting business." The regulations implementing this section expand the criminal statute. Now it is a federal felony punishable by imprisonment of up to five years to operate an MSB without a license in a state that requires a business to be licensed, to fail to comply with the FinCEN registration requirements, or to knowingly transmit money derived from or intended to finance criminal activity.

Most MSB operators failed to foresee how people could launder money, and criminals would exploit their payment systems. As a result, in 2007, the U.S. Department of Justice ("DOJ") brought an indictment against a payment system operator and its directors under the revised Section 1960 for operating as an unlicensed MSB.[15]

As part of these criminal proceedings, the court entered an order adopting the U.S. Treasury Department's expansion of the definition of money transmission to include not "only transmissions of actual cash or currency" but also "a transmission of the *value* of that currency through some other medium of exchange." The directors and operators of that payment system pled guilty to conspiracy to engage in money laundering and the operation of an unlicensed money transmitting business and agreed to pay a $3.7 million fine.

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[13] New York State Department of Financial Services (2016, June 13) DFS Grants Virtual Currency License to XRP, II, LLC, An Affiliate of Ripple [Press Release] *available at* https://www.dfs.ny.gov/about/press/pr1606131.htm.

[14] Pub.L. 107–56, 115 Stat. 272, H.R. 3162.

[15] *See United States v. e-gold*, No. 1:07-cr-00109 (RMC) (D.D.C. Apr. 24, 2007). Memorandum Decision, *United States v. e-gold*, 550 F. Supp. 2d 82, 94 (D.D.C. May 8, 2008).

In March 2013, the Treasury Department issued additional guidance from FinCEN that appeared to follow the DOJ indictments in 2007. The guidance was "to clarify the applicability of the regulations implementing the Bank Secrecy Act to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies." Importantly, it created two types of cryptocurrency actors: "exchangers" and "administrators." An exchanger was defined as anyone "engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency." FinCEN defined an administrator as anyone "engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency."

Most importantly, the 2013 Treasury Department guidance provided that all MSB regulations applied to both real and virtual currencies. Therefore, exchangers and administrators are money transmitters that must register as MSBs, unless an exception from registration exists. Specifically, the 2013 guidance stated that "accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter . . . ."

As registered MSBs, these businesses are subject to certain additional requirements under the Band Secrecy Act and its implementing regulations and are required to develop robust anti-money laundering compliance programs. The federal government is currently relying on authority pursuant to 18 U.S.C. Section 1960 and the FinCEN guidance to pursue cryptocurrency exchanges that it believes are engaged in illegal behavior. In the past two years, the DOJ has brought criminal cases in Arizona, Colorado, Maine, Missouri, New York, and Ohio alleging the operation of unlicensed MSBs related to cryptocurrencies in violation of Section 1960.

CONCLUSION

Cryptocurrencies and blockchain are groundbreaking technologies whose very intent is to disrupt traditional markets and the old way of doing things. Despite that, the system fights back. While the rules and regulations ultimately applicable to cryptocurrency may look different from what we have seen historically, the fact is there will be rules and regulations and they will have their foundation in traditional legal mores.

It is therefore vitally important that financial institutions understand what cryptocurrency is, the regulatory risks it faces, and how to operate within the relevant and ever-changing laws governing its institution. A financial institution that does not implement risk management related to this regulatory scheme does so at its own peril.